No. 84101-2

Court of Appeals No. 38247-4-II

WASHINGTON STATE SUPREME COURT

WASHINGTON STATE DEPARTMENT OF REVENUE,

Petitioner,

v.

WASHINGTON IMAGING SERVICES, LLC,

Respondent.

RESPONDENT'S SUPPLEMENTAL BRIEF ON REVIEW

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

I. INTRODUCTION

Pursuant to RAP 13.7(b), this supplemental brief shall address only the questions raised in the Department of Revenue's ("DOR") Petition for Review ("Petition").[1] In its Petition, the DOR argues that there are two reasons for the Court to have accepted review.

First, the Court of Appeals misinterpreted the meaning of "gross income" as defined in RCW 82.04.080, failing to understand, according to the DOR, that in the prior decisions of this Court ". . . the tax liability of the parties turned on who contracted with whom for what." (Petition at 1) For this reason, the DOR argues that the decision may be read to imply a holding inconsistent with decisions of this Court. (Petition at 14)

Second, according to the DOR, the Court of Appeals decision allows taxpayers, who subcontract out a portion of the services they sell, to exclude from their gross income nondeductible costs of doing business.

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[1] Through its factually selective argument, the DOR seeks more than a reversal of the Court of Appeals decision. The DOR intends ". . . to continue to rely on *Wm. Rogers*, *Walthew*, *Pilcher*, and other Rule 111 cases." (Petition at 20) Through this Petition, the DOR seeks reinterpretation of *Walthew*, *Warner, Keefe, Arron, Costello & Thompson v. Dep't of Revenue*, 103 Wn.2d 183, 691 P.2d 559 (1984) ("*Walthew*") and *Medical Consultants Northwest, Inc. v. State*, 89 Wn. App. 39, 947 P.2d 784 (1997), both of which support the Court of Appeals decision.

It thereby creates a deduction not authorized by statute or rule. (Petition at 19-20)

Contrary to the DOR's repeated assertions, Washington Imaging Services, LLC ("WIS") patients agreed to be liable for, and paid for, the professional services rendered by Overlake Imaging Associates, PC ("Overlake"). By contract, WIS and Overlake agreed that WIS would have neither primary nor secondary liability for these professional services.[2]

The Court of Appeals decision does not create a significant tax deduction. WIS and Overlake could each bill separately for the distinct services they render. Insurance companies would match each of the bills to a single specific procedure for a single patient and issue separate checks

[2] Ironically, Justice Dore, in his concurring opinion in *Walthew*, 103 Wn.2d at 191-2, perceived some ambiguity as to whether the law firm was liable to the third party providers. He suggested that, to avoid having to litigate this issue, the taxpayer notify the third party service provider that the taxpayer would not be liable for the third party service provider's charges. In this case, the DOR takes the position that WIS' contract with Overlake, under which the parties agree that WIS is not liable for Overlake's professional services, cannot effect the tax liability for funds paid to WIS that include Overlake's fees. (Petition at p. 17, n. 4)

to WIS and Overlake.[3] The tax effect would be exactly the same as it is under the Court of Appeals decision. Only administrative costs would change since there would be twice as many bills issued by the providers for the same health care services and additional processing costs on the part of the insurance companies to match the multiple bills to the single procedure.

The Court of Appeals decision does not create confusion.[4] It is consistent with the decisions of this Court and the Court of Appeals that have addressed the issue. This consistent analysis provides businesses operating in Washington the ability to understand and predict gross income taxability under Washington law.

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[3] Insurance companies will not pay a bill for either the technical fee or the professional fee in isolation. Before insurance companies will pay either fee, they must have been billed for both the technical and professional fees and have been able to match the bills to a single procedure. (CP 97 L. 3-19)

[4] To the contrary, DOR's interpretation and application of the law has varied substantially. *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2003), reflects that at the administrative level, the DOR took the position that the taxpayer was functioning solely as a paymaster when it received payments from a client for work performed by the taxpayer's employees and then "passed through" those payments as wages to its employees for which it was primarily liable. The DOR deemed these client payments not to be gross income to the taxpayer and issued the taxpayer a $257,000 refund. *City of Tacoma*, 148 Wn.2d at 174.

II. STATEMENT OF THE CASE

A. UNDISPUTED FACTS.

1. WIS

WIS is a Washington limited liability company that operates medical imaging facilities in Washington. (CP 31; 91 L. 14-15) WIS provides the equipment, a trained staff of technicians, and the supplies necessary to produce medical images. (CP 31) WIS is owned, in part, by a non-physician. (CP 30)

Treating physicians send their patients to WIS to obtain medical image information in the form of a written report that will assist them with diagnosis and treatment of their patients. (CP 92 L. 2-5; 145) To accomplish this purpose requires both the production of the medical image, which WIS does, and the professional medical interpretation of that image by a radiologist, which WIS does not, and cannot, do. (CP 146)

2. Overlake

Overlake is a Washington professional services corporation that employs radiologists. (CP 31) By contract with WIS, Overlake provides radiologists to interpret the medical images WIS produces. (CP 31, 146)

3. The WIS – Overlake contracts

WIS and Overlake have two contracts. (CP 37-59; 60-62) The first contract governs the terms and conditions under which Overlake provides the professional medical services of its radiologists to interpret the medical images produced by WIS. (CP 37-59) Overlake employs the radiologist and is solely responsible for all financial arrangements with them, and for their professional qualifications and performance. WIS has no control over the manner in which the Overlake radiologists perform their professional functions. (CP 37-50)

Under the second contract, WIS bills for and collects both its technical fee and Overlake's professional fee. Overlake's compensation for professional medical services is a percentage of amounts collected. WIS agreed that it would have no ownership interest in that portion of payments agreed to be for Overlake's professional fees, but was merely to act as the collection agent for Overlake for these fees, to be deposited as directed by Overlake. Overlake also agreed that WIS could bill for its fees and Overlake's fees in one global bill. (CP 60-62)

4. Provision of Services

Pursuant to the order of the treating physician, WIS contacts the patient and schedules the patient for the requested medical image. (CP 145) Upon arrival at the WIS facility, the patient completes a registration form that states, in part:

> I, the undersigned, hereby consent to and permit Washington Imaging Services, LLC (WIS, LLC), their designees, and all other persons caring for me to perform and administer tests, examinations, including but not limited to x-rays, medical and surgical treatment and other procedures which may be deemed necessary or advisable for me. (CP 141; 145)

The registration form also contains the following terms of Financial Agreement:

> PRIVATE PAY: The undersigned agrees, whether signing as agent or as patient to be financially responsible to Washington Imaging Services, LLC for charges not paid by insurance. I understand this amount is due upon billing.
>
> INSURANCE COVERAGE: I hereby assign payment directly to Washington Imaging Services, LLC for benefits otherwise payable to me, but not to exceed the charges for service. Any portion of charges not paid by the insurance company will be billed to me and is then due and payable within 30 days of invoice. (CP 141; 145)

Once the patient completes the required paperwork, a WIS technician takes the medical image ordered by the treating physician.

(CP 145) As a matter of practice, patients are informed that the final product will be interpreted by a qualified physician and that the results of the interpretation of the image are generally available within 24 to 48 hours. (CP 33; 134)

WIS provides "reading stations" at its facilities where the Overlake radiologists may examine and interpret the image. (CP 146) In the medical community that WIS serves, the doctors who refer their patients to WIS are well aware of who WIS uses for the professional interpretation of the medical images it produces. (CP 146)

The radiologists dictate their interpretations of the medical images and dictation is transcribed by WIS staff into a draft report for review and approval by the Overlake radiologist. (CP 146) Once the Overlake radiologist has signed the report, WIS transmits it electronically to the treating physician. (CP 146)

5. Billing and Payment

The charges for the production of the requested medical image by WIS are referred to as technical fees. The charges for Overlake's professional medical interpretation of the image are referred to as professional fees. (CP 146-147) For each medical imaging services

transaction, WIS issues a single bill that combines both the technical fee and the professional fee into a single charge. This form of billing is referred to as global billing. Global billing is the customary practice in the outpatient medical imaging business. (CP 146-147)

Insurance companies prefer global billing. (CP 147) It is far more efficient and, therefore, less expensive, for the health insurance companies to deal with a single bill that contains all charges for a health care service than to deal with two partial bills for the health care service. (CP 96; 147) The contracts that WIS has with health insurance companies to be a provider are set up for global billing. (CP 95 L. 12-17)

WIS initially bills the global charges to the patient's health insurance company. (CP 147) The patient is informed of this billing through a statement sent by WIS. (CP 94) Regardless of what WIS states as a charge for services, each insurance company has a set reimbursement allowance for the technical and the professional services provided to its insured. This reimbursement allowance, not WIS' billed amount, determines what will be paid. (CP 143; 147)

The insurance company payment is global. It does not break out the amount paid for the technical or professional fees. (CP 148) If the

insurance company does not pay the full amount, the patient may have either a co-pay or deductible payment responsibility. (CP 147) The patient is informed of this through an explanation of benefits form sent by his or her health insurance company. (CP 94) If appropriate, WIS will send a secondary bill to the patient for the patient's portion. The secondary bill to the patient identifies the radiologist who interpreted the image, the initial charge for all services, the adjustment of that charge by the insurance company, the amount paid by the insurance company, and the amount owing by the patient under his or her policy. (CP 143; 148) Any secondary bill sent to the patient will necessarily be global. (CP 147)

6. Professional Fee Pass Through to Overlake

WIS passes through to Overlake, as payment for its professional medical service, an agreed percentage of what WIS collects on a bill for a medical imaging transaction. (CP 148) WIS has no ownership interest in this portion of the payment, is to deposit Overlake's compensation as directed by Overlake, and is to provide Overlake periodic collection reports. (CP 61) Beyond passing this agreed amount through to Overlake, WIS has no liability to Overlake for its professional fees. (CP 34) If the global

bill issued by WIS is not paid, WIS has no obligation to pay anything over to Overlake for its professional services. (CP 28)

III. ARGUMENT

A. THE COURT OF APPEALS CORRECTLY DETERMINED THAT FUNDS PAID FOR THE PROFESSIONAL MEDICAL SERVICES RENDERED BY OVERLAKE ARE NOT GROSS INCOME TO WIS.

RCW 82.04.220 levies a tax on every person for the privilege of engaging in business in the State of Washington to be measured, as applicable here, by the application of tax rates against the gross income of the business. As relevant, RCW 82.04.080 defines "Gross income of the business" as:

> . . . the value proceeding or accruing by reason of the transaction of the business engaged in and includes . . . compensation for the rendition of services, . . . all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses. (Emphasis Added)

In turn, the phrase "value proceeding or accruing" is defined in RCW 82.04.090 to mean:

> . . . the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which

> method of accounting is regularly employed in keeping the books of the taxpayer. (Emphasis Added)

1. The funds that WIS collects and passes through for the professional services rendered by Overlake are not actually received by or accrued to WIS.

WIS bills for the professional services rendered by Overlake under an agreement that provides, in part:

> In addition, WIS agrees to act as collection agent for Overlake. WIS agrees to timely and accurately collect Overlake's professional fees utilizing its normal collection procedures. WIS shall have no ownership interest in the Overlake portion of the billing and is acting exclusively as a collection agent for Overlake. As received, WIS agrees to deposit Overlake fees as designated by Overlake. WIS shall provide Overlake monthly, or more often, collection reports. (Emphasis added) (CP 61)

Funds received by a business, in which the business has no ownership interest and that must be deposited as directed by the third party owner, cannot constitute the actual cash receipts of the business nor can they be funds actually accruing to the business. Therefore, under the statutory definition of "gross income," the funds WIS collects and passes through to Overlake cannot constitute "gross income" to WIS.

2. The funds that WIS collects for professional services and passes through to Overlake are not compensation for services rendered by WIS.

An example of what is meant by "value proceeding or accruing" to a business under RCW 82.04.080, and the only example directly applicable to WIS, is ". . . compensation for the rendition of services. . . ." WIS does not and, as a matter of law, cannot render professional medical services.

Just as the law firm in *Walthew,* 103 Wn.2d 183 at 187-88, was prohibited from being ultimately responsible for litigation expenses for a client's lawsuit, so too is WIS legally barred from rendering professional medical services because it has non-physician ownership. (CP 30) In *Morelli v. Ehsan,* 110 Wn.2d 555, 756 P.2d 129 (1988), a physician and nonphysician entered into a partnership to operate an emergency and family-care clinic. *Id.* at 556. The nonphysician argued that the partnership was legal because his responsibilities and duties were strictly limited to business aspects, while the physician's authority was limited to medical affairs. The court rejected this distinction, holding that the clinic partnership agreement provided the nonphysician with "a means and an instrumentality by which he shared equally in the profits and management of a medical practice."

Morelli, 110 Wn.2d at 561. The court further held that both the physician and the nonphysician had violated the prohibition against the corporate practice of medicine by operating a clinic without both being licensed as physicians. *Id.*

By law, WIS cannot share in the management or profits of a medical practice and it does not. Overlake is solely responsible for management of the medical practice and the hiring, evaluating, and paying of the employed physicians. (CP 31-32; 40-45) WIS has no ownership interest in the portion of the funds collected for, and passed through to, Overlake for the professional services of the radiologists it employs. (CP 61)

In *Walthew*, 103 Wn.2d at 187-88, this Court made clear that taxable gross income is limited to compensation received by the taxpayer for services rendered by the taxpayer.

> Compensation or consideration for the service is thus the basis for the tax. (Emphasis Added)
>
> . . .
>
> Nothing in the statute refers to exceptions on the basis of agency and liability. The language in Rule 111 is consistent with the statute if it is read to reflect the statute's obvious intent to tax only gross income which is "compensation for the rendition of services" (RCW 82.04.080) or

"consideration . . . actually received or accrued" (RCW 82.04.090). (Emphasis Added)

In *Walthew*, as it does here, the DOR argued that because the third party service providers benefitted the taxpayer and because these services were necessary for the taxpayer's business they were a cost of doing business. *Walthew* rejected the DOR's argument based on the language of RCW 82.04.080 and RCW 82.04.090. As is true in this case, the funds at issue in *Walthew*, funds paid by the clients to the law firm, were not compensation for the rendition of services by the law firm, but rather were to pay for services essential to the business of the law firm but rendered by third party providers with whom the law firm contracted.

3. Overlake's professional fee is not a labor cost or other expense of the services rendered by WIS.

The DOR argues repeatedly in its Petition that the Overlake fee for the professional services it renders to WIS patients is a cost of WIS' business because WIS is contractually obligated to collect the fee and to pay it over to Overlake. This argument confuses patient liability for the Overlake professional fee with WIS' contractual obligation to collect that fee and assure it is passed through to Overlake.

The undisputed facts establish that WIS patients both assume liability for the professional fee and pay it. Each patient referred to WIS signs a registration form before receiving any service in which each patient authorizes WIS to procure for the patient such medical services as are deemed necessary. Each patient agrees to be financially responsible for all services provided, either personally, or through assignment to WIS of his or her health care insurance benefits. (CP 141; 145)

Once the patient has discharged his or her liability for the professional services rendered for his or her benefit, WIS' contractual obligation is to assure that the professional fee is passed through to Overlake. There is no material difference between this arrangement and the situations in *Walthew* or *Medical Consultants Northwest, Inc. v. State*, 89 Wn. App. 39, 947 P.2d 784 (1997).

In *Walthew*, the client did not enter into an agreement with any process server or court reporter, or business employing either, to pay them for their fees. Rather, the client agreed with the taxpayer to be liable for these and other costs. Incident to prosecution of a client's claim, the law firm choose the process service provider and the court reporting provider, and agreed to the price for the service with each of these third party

providers. The law firm's obligation was to assure that the third party services provider's fees and costs, for which the client was liable, were paid to the providers the law firm hired to render the third party services.

The same is true in *Medical Consultants Northwest, Inc.* The taxpayer's clients did not enter into any direct agreement with the physicians for performance of the independent medical examinations. The taxpayer's clients agreed with the taxpayer that they would be responsible for these costs in addition to amounts charged by the taxpayer for its distinct services. The taxpayer selected the physician to perform the independent medical examination, negotiated the compensation the physician would receive for the service, and was responsible to assure that the client's payment of the negotiated amount was remitted to the responsible physician.

The factual situations presented in this case, and in *Walthew* and in *Medical Consultants Northwest, Inc.* are materially different from those presented in *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2003), and *Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 49 P.3d 947 (2002). These latter two cases illustrate that our courts are fully capable of distinguishing true "cost of doing business" situations, in which

the taxpayer is ultimately liable for the cost, from the pass through situations presented in *Walthew, Medical Consultants Northwest, Inc.* and this case.

In *City of Tacoma,* the taxpayer was the employer of record of the temporary staffing personnel. The taxpayer recruited, tested, and trained the temporary staffing personnel it hired and provided them with an employee handbook informing them they were the taxpayer's employees no matter where they worked. The taxpayer billed the client for the services of its employees and provided its clients with a money-back satisfaction guaranty for their work. The taxpayer remained liable to pay its employees if the client failed or refused to pay the charges billed by the taxpayer for its employees.

This Court distinguished *City of Tacoma* from *Walthew* and *Christensen, O'Connor, Garrison & Havelka v. Department of Revenue*, 97 Wn.2d 764, 649 P.2d 839 (1982), noting that in these latter two cases ". . . the taxpayer clearly had no liability for the payments." *City of Tacoma*, 148 Wn.2d at 177. In light of the DOR argument in this case, it is important to note that the key issue is liability for the payment, not a contractual or other obligation to assure that the payment makes its way

from the liable party through the taxpayer to the third party service provider for services rendered. As this Court reminded the parties in *City of Tacoma,* it is the taxpayer's liability in its own right for the payment that makes the payment a cost of doing business and not a pass through.

> As we stated in Rho, "If Rho is the employer, then Rho is liable in its own right for the payment, and Rule 111 does not apply." Rho 113 Wn.2d at 569.

City of Tacoma, 148 Wn.2d at 178.

Again in *Pilcher v. Department of Revenue,* 112 Wn. App. 428, 49 P.3d 947 (2002), the court emphasized that the taxpayer was solely liable for the payments in question.

> On this point, the trial court conclude that Dr. Pilcher was solely responsible for paying the physicians he retained, regardless of whether the Hospital paid him or whether the patients paid the Hospital. The trial court's findings of fact, and the evidence in the record on which those findings are based, support this conclusion.

Pilcher, 112 Wn. App. at 441.

IV. CONCLUSION

The DOR seems intent on perceiving implications in the Court of Appeals decision that it can then point to as support for its insistence that this decision is in conflict with decisions of this Court and of the Court of

Appeals. For example, the DOR argues this decision implies a taxpayer may exclude from its gross income funds paid it by a client for services rendered by a third party even if the client has no liability for the services. (Petition at 14)

The implication that the DOR perceives for purposes of its argument is completely divorced from the undisputed facts of this case. The insurers were fully aware of the professional services component of the WIS bills, recognized their liability, on behalf of their insured's, for these payments, and made the payments in response to the WIS global bills. The patients themselves agree to be financially responsible for all medical services furnished them, were informed that those services included the creation and the interpretation of the medical images ordered and, when billed directly, were informed of the identity of the physician who performed the professional interpretation of the image.

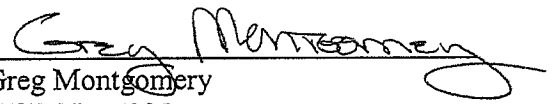
The Court of Appeals decision is consistent with all previous decisions of this Court and the Court of Appeals in which clients of a taxpayer have agreed with the taxpayer to be liable for payment for services to be rendered for their benefit by a third party: (i) retained by the taxpayer; and, (ii) paid based on an agreement reached between the

taxpayer and the third party. Funds paid by the client to the taxpayer to discharge the client's liability to a third party service provider do not become gross income to the taxpayer when it collects these funds and transmits them to the third party service provider. This Court should decline DOR's request to change the analysis in this area of the law that has been consistently applied by this Court and the Court of Appeals for more than twenty-five years.

DATED this 28th day of May, 2010.

Respectfully submitted,

MILLER NASH LLP



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